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ASIAN EXPERIENCE IN TRADE AND INDUSTRIAL REFORM

Mohammad Sadli

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PREFACE

The International Center for Economic Growth is pleased to publish *Asian Experience in Trade and Industrial Reform* by Mohammad Sadli as the forty-seventh in our series of Occasional Papers, which present reflections on broad policy issues by noted scholars and policy makers.

This paper was originally submitted to the General Session of the Fifth Asian Development Bank Round Table on Development Strategies, held in Manila on March 8, 1993. A panel discussed the paper under the general theme of "Economic Reforms for Sustainable Development."

Mohammad Sadli looks at the experience of the Asian developing countries in achieving trade and industrial reforms, particularly drawing on his intimate knowledge of Indonesia. He first takes a look at the history of the countries after they achieved independence and at the domestic and international factors that caused reforms to gain momentum in the 1980s.

Turning then to the issues surrounding trade and industrial policy reforms, the author examines both the problems and successes of such questions as removing trade barriers, controlling domestic trade, and reforming industrial policy. Whether trade should be oriented toward internal or external markets, what the role of foreign direct investments should be, how technology can be transferred, and how governments support industrialization are only a few of the issues discussed in depth. The author concludes that Asian developing countries must increasingly open their economies and establish sound macroeconomic environments.

Mohammad Sadli speaks from a unique perspective as a former chairman of the Board of Investments of Indonesia, a former minister of manpower, and former minister of mines and petroleum. He is also an emeritus professor of economics of the University of Indonesia and has been active in the Indonesian Chamber of Commerce.

As the developing Asian countries strive to achieve reforms and find a place in a global economy, the observations in this paper should be quite useful to economists and policy makers with an interest in the region.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
November 1993

ABOUT THE AUTHOR

Mohammad Sadli is emeritus professor of economics of the University of Indonesia. He was chairman of the Board of Investments of Indonesia, 1967–1973; minister of manpower, 1971–1973; and minister of mines and petroleum, 1973–1978.

After leaving the government, he became active in the Indonesian Chamber of Commerce and Industry, as secretary general and chairman of the chamber's Institute for Economic Analysis, Research, and Development.

He has served on task forces for the World Bank, the International Monetary Fund, the Asian Development Bank, and the Association of South East Asian Nations.

MOHAMMAD SADLI

Asian Experience in Trade and Industrial Reform

Reasons for Reform: Domestic and International Factors

In the 1980s economic reforms gained momentum in the developing Asian countries, motivated by a combination of domestic and international factors. Which of the two was more influential is difficult to prove and may differ from country to country, from period to period, and from reform to reform.

Reform measures do not come overnight, triggered, for example, by an economic crisis. Often there have been preludes or previous timid attempts. The Indian reforms and deregulation, for example, are often attributed to the present government under Prime Minister Narasimha Rao, dating only from 1991. However, preludes could be heard at the time Prime Minister Indira Gandhi was in power, in response to the oil crises. Prime Minister Rajiv Gandhi then tried to promote exports and encourage foreign investments but could not push effectively because of political distractions.

In Indonesia the reforms gathered momentum in the middle 1980s, but the economic technocrats in government and academia had been exposed to the teachings and preachings of World Bank officials much earlier. Every year the World Bank and the International Monetary Fund (IMF) send missions to prepare reports on the state of the economy for the annual conference of Indonesia's international aid consortium, the Consultative Group on Indonesia (CGI). Such reports are civil exercises in policy dialogue. The Indonesian government, however, likes being given credit for acting independently, before international policy advises become pressing or near conditional. Its economic ministers have cultivated good relations and mutual understanding with officials of the Bank and Fund for much of the past twenty-five years. There has never been domestic political resistance against this relationship, perhaps because the stabilization and structural adjustment policies have borne fruit within a relatively short period and the supply responses were rather quick. Economic aid and capital inflows were also adequate. Economic reforms have come in a series since the beginning of the present Suharto government some twenty-five years ago. They certainly were not a one-time, big-bang affair.

Ideological factors. During the early days of independence many developing countries oriented economic policy around the role of the government as the guiding power to organize and reorganize the economy. The planning idea behind European socialism had greater appeal than capitalistic laissez-faire paradigms because of the first promised reforms of a colonial economy, enabled by the political power of the newly independent state, that is, the power of government. In the eyes of the new power holders and their followers, there were many things wrong in an economy left behind by a colonial regime; it served mainly the interests of the far-away metropolitan center, and it was controlled by aliens.

Restructuring then meant the promotion of the new national interest. Various means were resorted to in order to advance ownership of property into national hands, to control international payments, to license entry into an industry, and to give preference to nationals. Many developing countries did not institute a command economy with an all-encompassing public sector; those economies remain mixed, with a private sector of varying strength continuing to exist. Governments did, however, engage in "planning," meaning resource allocation through a government mechanism. Almost everywhere there is a planning agency and a minister for planning. The allocation of the capital budget of the government was the easiest to control. Investment in the private sector to a certain extent was directed by a licensing system, whereas imports were controlled by another licensing system.

Moreover, the state enterprise sector became an extension of the control mechanism of the government.

As many of those newly developing countries still had inadequate national savings, financing economic development was dependent upon foreign aid. Foreign aid, however, is a government-to-government affair, hence reinforcing public sector planning. Some countries, such as Indonesia, enjoyed oil booms in the 1970s with revenues accruing to the governments, which then were used to buttress their capital budgets and the priority sector lending operation of government banks.

Price controls. Price controls were rampant, partly as a consequence of the prevailing ideology, but also because of a perceived necessity to protect the society, that is, consumers, against the hazards of inflation. The newly independent states after World War II emulated the wartime economic controls practiced by the industrial countries, deeming such controls legitimate.

That price controls could not be exercised for too long without penalty was not realized. Of course a government hypothetically could practice extensive price controls without damaging the long-term growth of the economy if such a system politically and administratively could be neutral between the interests of consumers and producers, between consumption and investments. In practice, however, the interests of consumers prevailed because governments tend to appease the mass of the society whereas producers often are still afflicted by the colonial stigma. Moreover, state enterprises are not set up for their own growth but to serve the public good first of all.

Economic reforms aimed at fuller play of market forces eventually have to phase out most price controls, but such a process cannot be completed in a short period, if at all. Administrative price and rate setting is practiced with respect to public utilities and monopolies or cartels. Such market structures abound in developing countries because of the small size of the market. In Indonesia many commodities deemed "vital" or "strategic" (such terms date from World War II years) to the interest of the society remained subject to price controls, such as rice and wheat flour (basic foodstuffs), fertilizers (vital for the farmers), hydrocarbon fuels (production and distribution controlled by a state enterprise), and cement and steel (strategic). The adjustment of administratively controlled prices to continuing inflation at times becomes a very difficult political process, and the policy of deregulation still has to cope further with this problem.

International factors. The breakdown of the economic system of the European socialist countries made easier the liberalization of economies in many developing countries. It punctured the perceived superiority of the control system to support economic development. The greater success of East Asian countries in managing growth made more attractive a market-oriented model and an open economy fully interacting with the world. Apart from this counter-ideological influence, the drastic reduction of Soviet economic aid and guaranteed trade became a compelling reason for a number of countries to reorient their economic policies and emulate the more market-oriented systems of East Asian countries in order to have greater access to new markets and sources of financing.

Oil producing and exporting countries had to restructure their economies in the 1980s to lessen the dependence on oil revenues and promote non-oil exports. This change required a major reorientation of policies, away from an overvaluation of their currencies and toward providing incentives to new growth sectors through the price mechanism and macroeconomic policies. Oil importing countries had to restructure and reorient their economies to cope with higher-priced oil and increasing current account deficits. That is why Thailand started reforms earlier in the 1980s as a result of the second oil crisis.

Reform: A Political Process

These external shocks or influences and internal needs for adjustment have not produced clean and straightforward processes of reform. This is because reform is basically a political exercise. The old system, however deficient, always has its merits and beneficiaries. The mass of the people, being consumers, will get a shock when the prices of their daily necessities go up to a new equilibrium. They will not easily understand the macroeconomic needs for economic reform, the benefits of which will come only later. In a number of countries price and rate adjustments have sent people into the streets, protesting and demonstrating. In other countries, with different political regimes, the government seemingly could get away unscathed. Indonesia is probably one example of the latter.

No government, however, is totally immune to popular sentiments, and no government can completely break away from the past. The old system always has its strong advocates, or at least supporters of certain features, such as relative price stability thanks to price controls. Old teachings also die hard. Hence a process of zigzagging, or moving forward with occasional backtracking or moving sideways, has been more the order of the day.

Even in Indonesia, with a very strong government, economic pundits often complain that deregulation of the economy has proceeded too slowly, by fits and starts. Approaching the time of the meeting of the Consultative Group on Indonesia, there is usually a burst of new deregulation measures. Indonesian economic ministers, and even President Suharto, like to repeat their commitment to further deregulation. They mean what they say, but because of the inherent political process those ministers cannot always be on top of things.

The role of the government. There is a school of thinking that deregulation should proceed gradually, in stages, and that governments should not overreact or go overboard. Deregulation is practically a never-ending process and is a regular part of the functions of a government adjusting itself to changing needs and requirements. At the heart of this belief is a philosophy of the role of government. Deregulation should not be interpreted as abandoning the role of government in favor of a laissez-faire stance. Deregulation is a reinterpretation of the functions of government. Governments in developing countries remain proactive agents, guiding the development of the economy and society. In this process, however, they should now let market forces play a greater role in the allocation of resources and should not go against the market.

It is often said today that governments "should get the prices right." That may be good advice, but it gives no definition of what "right" means. Prices in the market are not always right because of market distortions. On the other hand, we have seen a lot of government interventions inimical to economic growth as well as equity. Hence the debate about the role of governments in setting prices right is a never-ending one, perhaps even, in retrospect, like the debate among western economists about the role of government in Korea in relation to its growth success.

Monopolies arise more easily in developing countries because of the size of the market. Governments in the past have even often created or supported such monopolies. Monopolies should be phased out when the market can support a greater number of suppliers without loss of efficiency. Periodically, old monopolies should be reviewed in the light of present-day market realities and efficiency options. Hence government has a distinct function to make the market mechanism work better by certain interventions. Such interventions should be based on transparent rules and mechanisms.

Is it possible for developing countries to have a "smart" government, or bureaucracy, handling control mechanisms? What does "smart" mean? If the ministers and their staff have doctorates in economics, would that be an assurance? If the government follows IMF and World Bank advises, would that be another assurance? In Indonesia we have a technocratic system (professional rather than influenced by party politics and ideology), but the decisions have not always been smart. Inflation control, stability, and transparency of policies still can be improved.

For one thing, political influences play a part, such as the tug-of-war between consumers' and producers' interests, between development impatience and macroeconomic prudence. For another thing, information for decision making is often not adequately and timely available. If the government or bureaucracy establishes close relations with the business community and its organizations for better feedback of information, as is often perceived to be the case in Japan, would that produce better decisions? Perhaps, but those decisions may be tilted toward the interests of such business organizations. That may be legitimate if one can assume that what is good for the chamber of commerce is also good for the country. Many economists may doubt the merits of such a proposition, because the national chamber could represent a lobby of business monopolies and other interest groups that may be tilted toward protection. On the other hand, if a system is inclined more toward the interests of consumers than producers, such a system may be less sustainable in an inflationary environment. The trouble is that abandonment of the price control system in such an environment is often politically unacceptable.

Macroeconomic stability and low inflation. If a government wants to abandon the price control system, it must be able to deliver price stability through proper macroeconomic policy measures over a sustained period. This is the latest proposition in Indonesia, where the government recently announced a 5 percent inflation rate target for fiscal 1993–94, and probably beyond. Its track record has been closer to 10 percent per annum, but the instability that high inflation brings with it and the political costs of making the adjustments are in the end deemed not worth the while because these efforts are sapping the strength, the credibility, and the goodwill of the government.

Of course, it is much easier to set a low-inflation target than to execute it. Moreover, if low inflation is not hard to achieve, why the past record? Why are Singapore, Malaysia, Brunei, and Thailand low-inflation countries whereas Indonesia and the Philippines are not known as such? The answer must lie in the governmental and political sphere, including institutions (such as the independence of the central bank and the role of the bureaucracy) and traditions. If a country does not have a tradition of monetary stability, it is not easy to establish a new one.

Early Industrialization Policies and the Need for Reform

Having discussed several of the factors leading to economic reform, we come now to the problem of trade and industrial policy reforms. Why is it that the Asian countries needed them so badly? In the early days of independence, or immediately after World War II, the developing countries wanted to modernize their economies and create greater prosperity. The leading strategy was industrialization. For industrialization one needs markets. Foreign markets look forbidding for the uninitiated. The domestic market in many countries looks to be the easiest way to serve. Small countries, such as the newly industrializing economies (NIEs), found out early that they did not have such options for too long and went out the hard way to sell abroad. In many developing countries, however, the size of the domestic market spawned the doctrine of import substitution industrialization, with an important footnote, that is, under high protection.

This led first of all to control of imports for the sake of protection. Control of imports had another, equally strong, motivation: conservation of scarce foreign exchange. Of course one could do the same through a more open market system, by not overvaluing the currency and by setting high tariffs for unessential goods without resorting to quantitative restrictions. Overvalued exchange rates are difficult to correct timely in countries with a tradition of high domestic inflation. Hence import controls are usually resorted to through the imposition of high tariffs, quantitative restrictions, and a licensing system. Such systems, however, work against the interest of exports as these become less profitable propositions.

Sooner or later these developing countries faced a balance of payments crisis and were forced to abandon such regimes in favor of systems favoring exports. They had to decontrol the foreign trade and exchange regime and adjust industrial policy to give greater incentives to exports. Most of this happened in the 1980s, apart from the NIEs that had embarked upon export-oriented industrialization much earlier by force of circumstance.

Trade and industrial policy reforms are two sides of one coin. The Asian Development Bank (ADB) publication *Asian Development Outlook 1991* says: "Under any long-term structural reform program, trade and industrial policies need to be closely coordinated. Liberalization of an economy's external trade sector, if not accompanied by reforms in the industrial policy, is bound to fail."[1]

Conceptually, this is right. But in practice it is never a black-or-white proposition. There are a lot of variations and sequences that form different shades of gray. Trade policy reform reducing quantitative restrictions could be a response to a balance of payments crisis starting with a devaluation. The reduction or removal of quantitative restrictions is sometimes a fiscal device to improve government revenue collection from foreign trade. With import quantitative restrictions and a licensing system, the importers and traders are pocketing the economic rent, not the government.

Trade policy reforms, however, can be undertaken without an immediate need to reform industrial policy. If the Association of South East Asian Nations (ASEAN) wants to start economic cooperation through a trade preferential system, the individual member countries can cut tariff rates without intending to change their industrial policy much. Of course, the state of industrial policy will influence the boldness of the tariff reductions. If in the end ASEAN produces a consolidated list of items for tariff reduction as compared to individual countries offering reductions (perhaps with a great number of exclusions), then in the end trade policy reforms, for whatever initial reasons, will affect the state of domestic competition and in turn impact on industrial policies.

Trade Policy Reforms

Trade policy reforms are usually started in the international trade sector. Such reforms consist of lowering tariff rates, narrowing the range of tariffs, and removing trade barriers such as import quotas and bans, the import licensing system, assigned channels for the exclusive importation of certain commodities, and other administrative, legal, or institutional restrictions.

Many developing countries have erected high tariff walls to protect domestic industries and to control imports of unessential goods to preserve scarce foreign exchange. Apart from high tariffs, they also have instituted nontariff barriers (NTBs). The question is, What are the imperatives for these countries to lower such barriers, and at what times?

If such countries start an export promotion drive, is it inherently necessary to liberalize the import regime? The theory is that a restricted import regime will produce a high costs economy that will be counterproductive to an export drive. On the other hand, if the import regime is liberalized, imports may increase faster than exports, and the balance of payments will risk high and unsustainable current account deficits. Imports will certainly increase because of additional requirements for raw materials, capital goods, and other inputs to enable new exports. Those requirements are self-financing, but the society may also embark upon a buying spree of consumer goods and durables, perhaps as a result of pent-up demand. How should the country deal with such a problem?

First, the macroeconomic stability should be upheld. Exchange rates should not be, or become, overvalued, because this will encourage imports and work against exports. Second, demand management should be the basis of inflation control. Beyond such measures, however, there is no inherent logic that prescribes a developing country to liberalize its import regime to protect its export drive. Countries such as Japan, Korea, and Taiwan are known as examples of mercantilist regimes where a very successful export performance can go together with a not-so-open import and domestic trading regime. The 1991 United Nations Conference on Trade and Development (UNCTAD) *Trade and Development Report* concludes: "Taken as a whole, the results indicate that rapid export growth was critical to economic performance in the past decade, but there is no simple link between protection and export success. It is not trade policies in general, but rather how specific countries manage them that really determines economic performance."[2]

Should Hong Kong and Singapore always be the preferred model or could late starters like Indonesia, Thailand, and the Philippines not also engage in this "dual-track strategy"? Of course it should be an intelligent system. The high-cost elements burdening exports should be removed or compensation made. For instance, Indonesia has institutionalized an effective draw-back system to reimburse duties paid on imports of inputs for exported goods. The rupiah is protected from overvaluation through a gradual depreciation of the value over the year in line with domestic inflation. Exports of manufactured goods have been going up by 20 percent or more on an annual basis. There are critics, however, who claim that the fast growth of exports of Southeast Asian countries was because of the international relocation of labor-intensive industries from the NIEs and Japan, and hence it was supply driven. That may be true, but why have exports of the Philippines and South Asia not advanced with the same speed?

Liberalization of the import regime is based upon the following argument. Tariffs and NTBs are for the protection of domestic industries. The protection function should be based on an effective infant industry policy; it should be phased down and out over a specific time. The level of tariff protection should also not facilitate domestic producers setting near-monopoly prices because of the ineffectiveness of import competition. Tariffs also have a fiscal function. Thailand, for instance, has relied on such revenues. Hence there is a connection between trade reform and fiscal reform.

Although in the past such reforms have been difficult to implement, the present conditions are different. We live now in an environment where industries must be made export competitive and import substitution industrialization has lost its appeal. Within this new policy environment it should be more feasible to phase out protection of domestic industries from external competition. High tariffs will create producers' rent and induce prolongation of protection; it is better to have lower and more efficient protection. The fiscal function of tariffs also rejects high tariffs because revenues may be less than optimal. As industrialization progresses, import tariffs should be transformed into general sales taxes applying to both imports and domestic production, therefore having a more neutral effect. This trend is already visible in Indonesia, where revenues from import duties are becoming much less important than revenues from the value added (sales) tax (VAT). The 10 percent VAT has to be paid on all import goods. Moreover, developing countries should progressively collect more income taxes for equity reasons.

How have NTBs crept into the system? NTBs have no fiscal function. Why then impose import quotas and outright bans rather than rely on tariff protection? The argument often given is that high tariffs encourage smuggling and dumping, as well as underinvoicing and bribing of custom officials. Once the merchandise is inside the custom boundary, it is hard to remove from the market, adds to the supply, and pulls prices down. Domestic industry then complains about unfair and even cutthroat competition. It lobbies for an outright ban because if imported merchandise is spotted in the market it is easier to remove it. Such an argument may not be very sound but has nevertheless been effective for the spread of NTBs. In short, high tariffs are counterproductive for optimal revenue collection and over time induce the spread of NTBs. Therefore the argument is strong for the lowering of import tariffs and the reduction or removal of NTBs.

Adherence to the principles of the General Agreement on Tariffs and Trade (GATT) also obligates the lowering of trade barriers. Developing countries wishing to export manufactures to other countries must observe the quid pro quo: If you need my markets, you have to render me your markets in return. To a certain extent developing countries still could invoke the GATT Chapter IV "Special and Differential" principle, but as soon as exports of manufactures become important they have to play by the reciprocal principle.

The export regime has to follow the same principles of nondistortion of the incentive system. Primary commodity exports are sometimes taxed for fiscal purposes. Often export taxes or levies are used as a protection device for domestic industry. For instance, Indonesia has prohibited exportation of logs and rattan to promote domestic processing industries. The argument was that without this special protection and incentives the inertia of exporting the unprocessed raw material is a strong force. On the other hand, the forced industrialization conveys benefits to Java island (with Jakarta and Surabaya as metropolitan centers), where the processing industries tend to locate, while the outer islands suffer from reduced exports because of the ban. Hence we have a delicate distributional problem as a consequence of infant industry protection. Cement and palm (unprocessed cooking) oil are at times prohibited for exportation if domestic supplies run low and prices go up. Such temporary restrictions, however, hinder the cement industry in building a foreign market because of uncertainty in meeting contractual obligations.

Domestic trade and distribution. Domestic distribution is equally important and should not be left out in the trade reforms. Domestic trade and distribution are often also subject to restrictions for the sake of protection as well as for political and ideological reasons. In Indonesia there is a law barring foreigners from engaging in domestic trade and distribution. The Japanese international trading houses, called Sogo Shosas, are not allowed to engage in domestic trade. In practice, however, they can get around the law by setting up dummy corporations. Imports and exports are restricted to nationals, and the foreign investment companies also cannot set up their own distribution but have to do it through national companies. Previously, this restriction was directed to the Chinese (of foreign nationality), but because of the law the foreign investment companies cannot be exempted.

The distribution of a number of essential commodities, such as rice, fertilizers, and sugar, is entrusted to a parastatal agency, the Badan Usaha Logistik (BULOG, the logistical board). The purpose is to stabilize prices and supplies and to prevent speculation by private traders. The system dates from wartime experience but is continued because of the influence of ideology (for example, the role of state enterprises), monsoon-related scarcities, and inflation. Should these domestic distribution systems be deregulated also?

The question is, Are these systems creating more distortions repressing otherwise productive development, or does the national economy still need such protection? A clear-cut answer is not available, and that is why the removal of these restrictions may have to be spaced over time. When inflation is under better control, the economy is growing, and foreign exchange scarcities are not imposing anymore, monsoon-related scarcities could be compensated for by imports. Inflation and price control–related scarcities can be avoided by ins[illegible]ing stable monetary conditions through effective macroeconomic policies. Developing countries should learn to control inflation as they aspire to become NIEs.

The prevailing ideology favoring extensive state intervention is now shifting toward giving the private sector a much greater role but in a competitive environment. Such a competitive environment can be promoted by deregulation of the trade and distribution sector. Of course, legal development and endorsement of an open and competitive market system is also of paramount importance. Therefore, a competition law is not a luxury for developing countries.

Industrial Policy Reforms

Industrial policy reforms cover several aspects. First, there is the classical problem of basic orientation of industrialization—domestic market import substitution or orientation toward external markets. Second is the role of foreign direct investment. Third, and related to the second, is the problem of acquisition or transfer of technology. Fourth is competition policy. Fifth is the role of state enterprises in the industrial sector. Sixth, related to the latter, is the problem of privatization. Seventh is government promotional or support policies, such as subsidization, "picking winners," and government-industry relations. Eighth is manpower or labor relations policy. We will discuss them one by one, but only focus on the main options and their merits.

Trade orientation. Whether industrial policy should be domestic market oriented or export oriented will not be a hot subject of debate much longer. By now most developing countries have exhausted their domestic markets as the sole or main outlet for the products of domestic industry. They have run into serious balance of payments problems because exports have not gone up as fast as imports and payments for services, not to forget debt service payments. Hence exports should go up much faster and for that exports of manufactures are the best bet, since primary commodities face uncertain international markets.

The question often posed is, If all developing countries engage in vigorous export promotion of manufactured goods, where should these goods all go, marketwise? Imagine large and medium-size developing countries potentially able to export goods worth some US$50 billion to US$70 billion per year; the markets of the major industrialized countries would not be willing and able to absorb all those exports. At 7 percent growth rate of gross domestic product (GDP), the manufacturing sector will grow in double-digit figures, say 11 percent per annum or better. To achieve this, when the domestic market has lost its absorptive capacity, exports of such manufactures should grow by close to 20 percent per year, or doubling every four years. Or put another way, exports of manufactures should increase three times faster than the GDP growth rate. That is a high growth scenario. Probably, a medium growth rate scenario will require exports to increase double the rate of GDP growth, but economic growth may go below 7 percent per annum, and the mopping up of massive underemployment will take much longer. The high growth rate scenario was possible during the previous decades with respect to the NIEs, and, since the economic reforms in China, exports of the latter have also grown very fast, reaching about US$85 billion in 1992.

If the proposal is that all developing countries should grow the same way, perhaps the global trading system, as it is now, cannot stand it for too long. But what would be the alternative? A balance between domestic and external markets? A bootstrap operation for developing countries? If individually those countries would not be able to do this trick, would they be able to do it together? This leads to the proposition of regional trade cooperation and opening up of markets for each other. The best solution is of course a really open global trading system according to the new GATT rules. If world trade can expand, say 5 percent per annum, then developing countries, starting from a low basis, can achieve some 10 percent growth of exports and better for their manufactures. Of course, they should drop an extreme mercantilist attitude of being willing only to export but not to open domestic markets.

In Asia we have seen the growth of trade among Asian countries becoming greater than the growth of Asian trade with its traditional partners in the West, but that growth, again, is starting from a low basis. As an example, trade between Indonesia and China has increased fast since normalization of diplomatic ties not so long ago and has now reached a US$2 billion volume of two-way trade. That is trade between two poor but large countries with GDP growth rates of 7–10 percent per annum. Trade between East and Southeast Asian developing countries and Japan is also growing fast lately. These are encouraging signs that among developing countries, and between developing and industrial countries, there is still significant potential for increase in trade, once the regional and global trade regimes are liberalized.

Perhaps a safer formulation of a policy advise for industrial, trade, fiscal, and monetary policies is to fashion them such that the price and incentive impact becomes neutral between selling in foreign and in domestic markets. But if one has to err, it is better to do it slightly on the export promotion side. For instance, the local currency should not be overvalued; it is probably better to be slightly undervalued. Moreover, industrial policies should stress flexibility, efficiency, productivity, and competitiveness.

Foreign direct investment. Many, developing countries have encouraged foreign direct investment (FDI) to complement the resources for industrialization. Others, also a good many, harbor ambivalent attitudes. The latter realize they need FDI but are reluctant to pay the price (multinational corporations are also rent seekers to some extent) or want to protect their own fledgling national companies. Hence the entry of FDI is made subject to many conditions, such as joint ventureship, sometimes with majority national equity, phased divestiture, a negative or no-entry list, localization requirements, export requirements, limited access to the domestic market and credits from state banks, etc. Successful industrializing countries, such as Korea, have relied more on technology cooperation or procurement than on FDI. The Korean model, as well as the Singaporean or Hong Kong model, has been working well. When India has followed a similar strategy as Korea, however, it has not produced the same impact.

Let me quote from a review article by Dr. Kirit S. Parikh, head of the Indira Gandhi Institute of Development Research in Bombay. This institute has dispatched four researchers to study the experiences of Korea, Thailand, Singapore, and Indonesia and to see what lessons there are for India.

> It is often argued that DFI [direct foreign investment] brings technology. Foreign investors are supposed to bring in the latest technology required for global competitiveness. This technology spills over into other sectors who supply components and inputs. Also when DFI firms produce cheaper and better capital goods or intermediate products, the competitiveness of sectors which use these is improved. Thus the argument continues, DFI can lead to widespread technological improvements.
>
> On the other hand, it is argued that technology spillover is very small with DFI. It tends to form an enclave, is reluctant to part with technology and on its own does not increase domestic content unless forced to do so.
>
> In Thailand DFI was concentrated in the export oriented manufacturing sector and showed higher capital and labour productivity. Also it improved productivity, quality and technology of the local firms. The experience of Singapore also supports these beneficial effects of DFI. Korea has also seen the need to encourage DFI for bringing in new

> technology. Yet, both Korea and Thailand recognize that DFI does not necessarily lead to technology transfer. Domestic R & D and creation of an educated workforce are both seen as essential for successful technology transfer.
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> Korea has imposed, just as India, phased manufacturing programmes (PMPs). Unlike India, in Korea the PMPs have been quite successful. The criterion for PMP in Korea has been competitiveness and not just time as in India. When domestic content requirement (DCR) is imposed on DFI firms, if the components are not of international quality, competitiveness and exports will suffer. During the period that domestic component manufacturers absorb new technology to upgrade their quality, they will need protection and to that extent the DFI have to be given access to domestic markets. This is borne out, for example, by the fact that the import content of exported Maruti cars (produced in India in a joint venture with Suzuki of Japan) is higher than that of Marutis produced for the domestic market. Obviously, protection to domestic component manufactures has to be only for [a] limited period, otherwise the infants would never grow up.
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> The lesson is therefore clear. DFIs bring in new technology and induce technical change—with their backward linkages. Whatever measures the host country takes to speed up this process should be consistent with competitiveness.[3]

From the Indonesian experience since 1967, the author recalls (as the first chairman of the investment board processing the applications) that the decision of the new Suharto government to encourage foreign investments was part of a political strategy to solicit international support for its efforts to rebuild the economy. The more immediate need was for foreign aid and capital flows, not strictly FDIs. The government, however, recognizes that there is a political link between the disposition to render aid by the donor and a policy of encouraging FDIs in the recipient country. As a matter of fact, the link was more extensive; the IMF was reinvited to survey the economy and make policy recommendations. The ultimate aim was to pave the way for foreign debt rescheduling (debts before 1966), a stabilization loan, and further down the line World Bank involvement in creating an aid consortium.

In Indonesia at that time the greatest attraction for foreign investors was the country's natural resources, especially its oil and gas potential, which the national company still cannot explore and develop because of lack of know-how and capital. North American companies were attracted to this natural resources sector, whereas Japanese investors were more attracted to the domestic (import substitution) market, which the new foreign investment law allowed. Why not restrict FDIs to the export sector only? Because in those days the urgent need was also for investments in general to rebuild the economy. Domestic capital had largely fled the country during the time of the less-hospitable Sukarno regime. The attraction of FDI was also intended as a pathbreaker, as a trigger, for the return of such domestic capital.

The cost of attracting FDI indiscriminately was recognized by the government economists at the time—for example, possible displacement of national companies, the consequence on the balance of payments through dividends and royalties outflows, and the increase of imports to produce consumer goods. There were even warnings from foreign friends (from the left-of-center) that FDIs could eventually exert political influence and subvert the national sovereignty. In the early 1970s such arguments emanated from Latin America. Probably the most potent driving force for the new government in Jakarta was desperation and the traumatic effect of the change of regime in 1965. Most restrictive economic policies from the previous regime were just reversed. That includes the new balanced budget policy as a reversal of the deficit financing from before.

Because economic nationalism never dies, the early liberal entry policies for FDIs were later amended. If in 1967 FDIs could come in with full control, after 1974 a joint ventureship became mandatory, and over time the local partner has to be given the opportunity to take over majority ownership. Localization of middle- and upper-level personnel was also appealed more forcefully. If domestic investments could further expand the industry (for example, in the cement industry), further FDIs were not encouraged much. During times of resources stringency, however, the door was opened more widely.

Now, with the emergence of an ASEAN Free Trade Area, it is recognized that the foreign investment policies of the country could not be less attractive as compared to neighbors such as Malaysia and Thailand. Even the emergence of China and Vietnam as competitors in the same league has produced second thoughts about the restrictiveness of the current foreign investment policies, and therefore current investment incentives are at times critically reviewed by business and the media and then modified by the government. Since industrial policies have swung more to export promotion, emphasizing competitiveness, the attitudes to FDIs have become more liberal. On the other hand, reforms of the legal basis for economic policy have always been very slow. Once the government tries to change a law, all kinds of atavistic arguments come out of the Pandora's box in parliament and in the political public, evidence that business needs and political emotions are still wide apart.

Technology policy. This issue overlaps with FDI policy. When Dr. Parikh discussed FDIs, the technology transfer aspect was uppermost in his mind. On the other hand, a country like Indonesia has no strong or integrated technology policy, although it has a minister for technology. On one hand, the technology minister has his pet projects, such as the development of a national aircraft industry; on the other hand, there is no clear-cut policy for promoting exports of manufactures, such as to pick winners and give them all-out support. As a matter of fact, the policy line has been "broad spectrum" promotion of manufactured exports. Because economic nationalism is strong and protectionist sentiments are respectable, however, the government has been giving strong support for the growth of the automotive, aircraft, and ship-building industries, albeit based mainly on the domestic market.

In foreign investment policy, however, there is no screening of technologies, and no ceilings have been imposed on royalties and other rewards for foreign technologies. The country may have incurred a lot of foreign exchange outflows because of this liberal attitude, but as a compensation the inflow of FDIs has continued to be very strong, regardless of the tightening of entry conditions over time. The recent figures are some US$8 billion of annual applications (on the basis of estimated cost of projects rather than on foreign equity), and this is outside the investments made by foreign oil companies for exploration and development, which by themselves amount to billions of dollars.

Dispersion of technologies and know-how is better in joint ventures than in FDIs under complete control by the principals, especially if the local partner is part of an aggressively expanding conglomerate. The local partner learns how and where to acquire technologies and supplies and later sets up a national company, trying to reduce costs by multiple and competitive sourcing. Compared to local companies, especially the conglomerates, many multinational corporation FDIs are distinctly conservative.

Competition policy. The preferred unit size, distribution, and market structure are important considerations in industrial policy, but controversies and inconsistencies abound. Conceptually there is an inclination to favor competitive markets and the absence of monopolies, oligopolies, and large companies because such a configuration appeals more to a common sense of equity.

In reality, however, large size connotes an efficiency and competitive strength that are deemed necessary to operate in foreign markets. State-owned companies are often large but escape the stigma that goes with private monopolies.

In industrializing developing countries there is an extensive small-scale enterprise sector that often has the political sympathy of the public because it is conceived as fighting a losing battle against the large enterprises. This situation spawned in India, some years ago, the reservation policy where a great number of industries were declared off-limits to large-scale production. This reservation list has since been reduced in the economic reform process. Taking a cue from India, in those days Indonesia flirted with the same idea, because even from Dutch colonial days a small number of industries were declared handicraft and closed for factory production (for example, making sarongs). Because of the greater labor intensity of handicraft and the pressure for employment, the idea of a reservation policy is never completely dead. The recent reforms in industrial policy, however, do not give priority to this option much longer, but the ambiguity and ambivalence remain.

In terms of size, the Korean model with its Chaebol conglomerates and the Taiwanese model of lesser concentration have intrigued policy makers in Indonesia. Ideally, they would prefer the Taiwanese model, but in reality only a small number of large concentrations have grown vigorously in the last fifteen years. A conglomerate is a large group of subsidiary companies (often a few hundred) under one group banner with a widespread diversification and often without a clear-cut "core business," or with a shifting one. Most of the Indonesian conglomerates are (Indonesian) Chinese owned and family controlled.

Should industrializing developing countries have a competition law, or an antimonopoly law, sooner rather than later? Governments may be ambivalent about introduction of such laws if they have growth and export performance in mind. Many laws in developing countries have a populist bent; hence in the end they may inhibit growth rather than promote equity. Currently there is no such law in Indonesia, although the chamber of commerce and political circles are championing it. In Indonesia, laws are introduced by the government and very seldom, if ever, by an initiative of parliament, although that is not what the constitution says. Asking around about the experience in other developing and Asian countries, the author found one intriguing answer, that a number of countries have such a law, but enforcement is lax. Such a law may have been the product of western influence. In Asia, a law often connotes an ideal situation rather than a basis for strict enforcement.

The current liberalization in trade policy, that is, the reduction of tariff rates and phasing out or removal of NTBs and import bans, will improve competition in the domestic market. The Indonesian government is in favor of competition, but it is rather silent on the merits or demerits of conglomeration and is making public relation noises that it is working on some kind of competition law, which it likes to call a law for protection of small enterprise. Its content, however, is still unclear.

State enterprises and privatization. State enterprises abound in Asian developing countries. In the reform of industrial policy, should they be phased out, reduced in number, or privatized? The fashion is for a market economy with a strong private sector. It is often held that private enterprise is superior in efficiency and performance to state enterprise, but in many Asian countries that is not a very obvious proposition. Private enterprises have also received a lot of support from their governments in their growth. Domestic private enterprises were often shielded from effective competition. Moreover, the family-held conglomerates have on occasion shown similar fallibilities of judgment and decision making and lack of professional management as can be asserted of state enterprises. If state enterprises are subject to political appointments of the top echelon, private enterprises are often only directed by family members of the owners. Many mishaps have come from such a source.

Hence, in industrial reform, putting large companies under competitive market pressures and exposing them to public scrutiny (for example, through obligatory publication of annual reports and balance sheets) is more important than changing ownership. Professionalization of management is equally important for the large private enterprises. Privatization can be done according to ownership (going public, or selling off state enterprises to the public) or according to management (introducing truly professional management and letting state enterprises compete in the market). Of course, this is easier said than done because the government, being the sole or majority shareholder, could appoint directors from its own ranks, just as presidents or important directors (such as the finance director) in private companies are members of the controlling family, all because of the strength of the one-share-one-vote mechanism of the limited liability company.

Government support policies. Although in neoclassical theory the government should remain neutral with respect to industrial policy, Asian predilections run counter to such a paradigm. When the government supported import substitution industrialization, it provided the necessary protection. Now that the dominant trend is promoting exports, support is to be given to the new option. The notion of "Japan Inc." has become popular in the export promotion environment of Indonesia today. The question is, By what measures should exports be supported: selectively or industry specific, or functionally across the board covering all sectors? The trend is toward the latter. The best choice is to establish a sound and stable macroeconomic environment of, say, low inflation and low interest rates and a not overvalued exchange rate. Trade policies should be liberalized to provide the optimum competitive environment; external trade and internal trade should interact competitively.

The temptation to "pick winners" should be avoided, but in practice it is not a black-or-white proposition. If a private industry has shown good potential for export of a certain product that is on face value not in the realm of the simple comparative advantage of the country, but the company may have developed a certain competitive advantage and found a market niche abroad, and if such an industry petitions the government for support, should the government remain a cool and uninterested referee? Examples are the export potential of the Malaysian Proton Saga Sedan, of the Korean Hyundai sedan, of the Indonesian Kijang-Toyota utility car. The answer may be that if the government can help on the basis of a functional policy applicable not only to the specific case, that would be a better policy than tackling it as an ad hoc, special case.

Labor relations policy. In Indonesia before 1966, labor unions were very politicized and radical. Some became extensions of the Communist party. Then this party was banned and the new government reorganized the trade unions along new lines, away from political party and ideological affiliations, and more in line with the German model, as industrial unions for collective bargaining but avoiding an adversary relationship between union and management. To prevent recurrence of ideological fractionalism, the government recognized only one national trade union movement. This has its pros and cons. Moreover, the government became very security and (political) stability conscious. Strikes are not officially banned but made very difficult. On the other hand, employers cannot discharge workers without government approval. Disputes are to be solved bilaterally without resorting to action by workers, but lock-out by employers is also rejected. If no bilateral solution can be found, then the case is submitted to a tripartite commission where the government (a representative of the Ministry of Manpower) presides. The decisions are binding.

The number of industrial establishments with unionized labor, however, is small and concentrated in the foreign investment sector. Small and domestic company establishments are most often not unionized. The labor market is fragmented, and organized labor is something of an elite. Workers in the unorganized or informal sector often earn subsistence-level wages. To force this sector to abide by formal rules of working conditions and minimum wages might result in lesser employment. Therefore, labor market reforms are dilemmatic in poor countries that have unlimited pools of labor.

Dr. Kirit S. Parikh, from the Bombay-based Indira Gandhi Institute of Development Research, links labor policy with "exit policy."

> The real cost of organized labour has been way above the costs of unorganized labour. A labour policy which protects employment operates in many ways. Labour laws make it extremely difficult to retrench any worker. Even economically unviable units are not permitted to close down. In fact such units are often taken over by the government. Along with this job security a number of other benefits are provided to workers.
>
> Labour policy reforms are desirable as a much larger group will benefit from a system that encourages productivity rather than one that protects the jobs of a few. In order to implement any kind of exit policy, the government must work first at developing a safety net for its labour force. Without a safety net an exit policy may be opposed strongly, but with it, reforms should be possible.[4]

Conclusion

Most Asian developing countries have engaged in extensive government interventions to prop up economic development because such was then the proper thing to do. Yet, this region of the world has also seen the fastest growth. International trade has been the engine of such growth, and exports of manufactures have been the leading commodities.

Countries such as Japan, South Korea, and Taiwan are not known as genuinely free traders. They are the modern mercantilists, vigorously exporting but restricting imports to save foreign exchange and protect domestic industries.

In today's and tomorrow's world of increasing globalization and a new GATT regime, on one hand, and managed trade practiced by the major players, on the other hand, the leeway for Asian developing countries to emulate previous Japanese, Korean, and Taiwanese models becomes very limited. Asian developing countries must increasingly open their economies.

Sectoral reforms toward deregulation and liberalization, however, do not proceed in a political vacuum; hence progress does not follow a straight line but will be a zigzagging and back-and-forth movement. Certain theories of reform strategies, such as "big bang" (or one big stroke) and bundled or phased packages, are interesting but not compelling for policy makers. In the end, the best choice is still to establish a sound and stable macroeconomic environment of, say, low inflation and low interest rates and a not overvalued exchange rate. Trade policies should be liberalized to provide an optimum competitive environment; external trade and internal trade should interact competitively. The key to productivity is still the force of competition, and the less the price system is distorted, the better chance there is for a more optimal allocation of resources.

NOTES

1. Asian Development Bank, *Asian Development Outlook 1991* (Manila: Asian Development Bank, 1991), 23.
2. The 1991 UNCTAD *Trade and Development Report* was quoted by Chakravati Raghavan in an article distributed by Third World Network Features, December 1992.
3. Kirit S. Parikh, "Learning from Tigers and Cubs," unpublished (Bombay: Indira Gandhi Institute of Development Research, 1992).
4. Ibid.

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